Financial Markets and Institutions

Abridged 10th Edition

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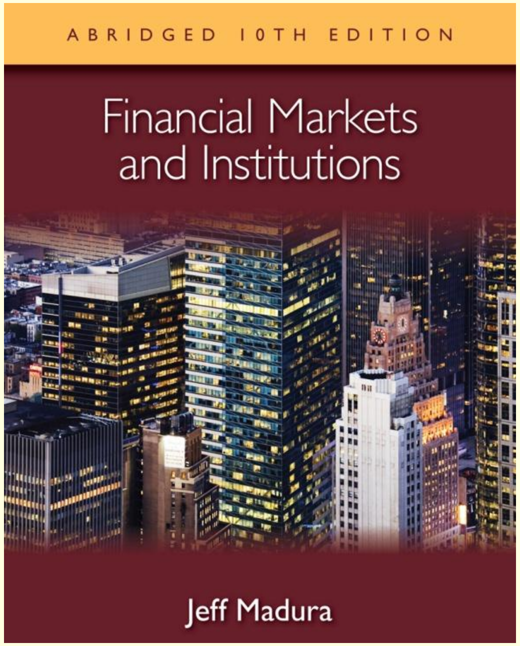


22 Finance Company Operations

Chapter Objectives

- describe the main types of finance companies
- identify the main sources and uses of finance company funds
- describe how finance companies are exposed to various forms of risk
- identify the factors that determine the values of finance companies
- explain how finance companies interact with other financial institutions

Types of Finance Companies

Consumer Finance Companies

- Provide financing for customers of retail stores or wholesalers.
- Provide personal loans directly to individuals to finance purchases of large household items.
- Provide mortgage loans.

Business Finance Companies

- Offer loans to small businesses.
- Provide financing in the form of credit cards that are used by a business's employees for travel or for making purchases on behalf of the business.

Types of Finance Companies

Captive Finance Subsidiaries

A wholly owned subsidiary whose primary purpose is to finance sales of the parent company's products and services, provide wholesale financing to distributors of the parent company's products, and purchase receivables of the parent company.

- **Advantages of Captive Finance Subsidiaries**:
  - Can be used to finance distributor or dealer inventories until a sale occurs, making production less cyclical for manufacturers.
  - Can serve as an effective marketing tool by providing retail financing. It can also be used to finance products leased to others
  - Allows a corporation to clearly separate its manufacturing and retailing activities from its financing activities.

Sources and Uses of Funds

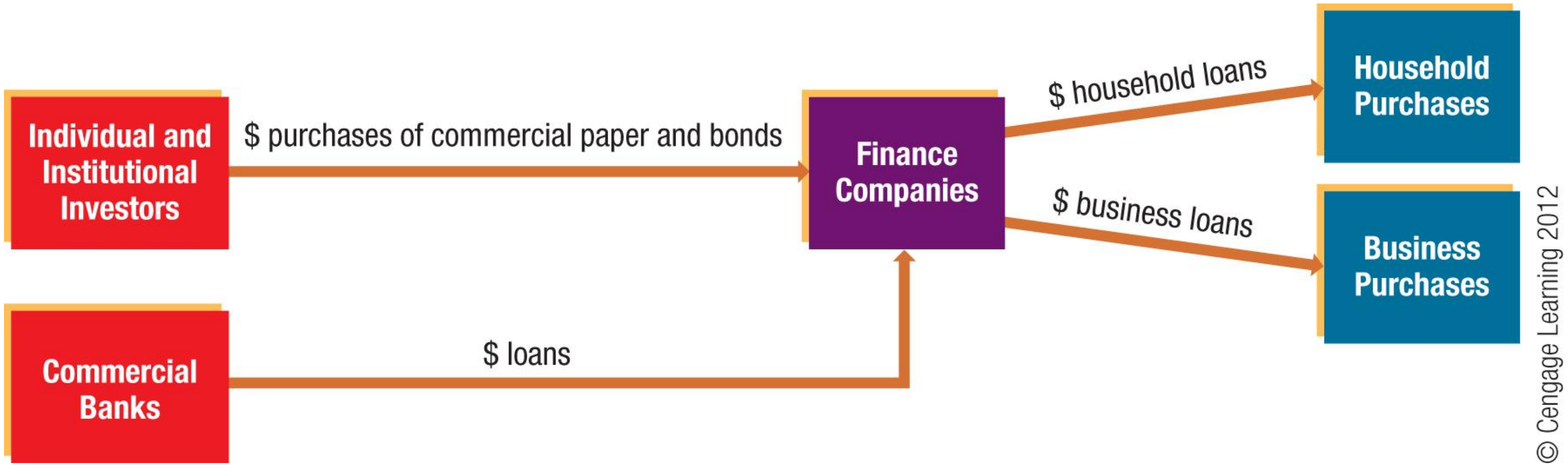
Sources of Funds

- **Loans from Banks** – Finance companies borrow from commercial banks and can renew the loans over time.
- **Commercial Paper** – Finance companies continually roll over their issues to create a permanent source of funds.
- **Deposits** - Some states allow finance companies to attract funds by offering customer deposits.
- **Bonds** - Finance companies in need of long-term funds can issue bonds.
- **Capital** - Finance companies can build their capital base by retaining earnings or by issuing stock.

Uses of Finance Company Funds

- **Consumer Loans** - Finance companies extend consumer loans in the form of personal loans.
- **Business Loans and Leasing** - In addition to consumer loans, finance companies also provide business (commercial) loans.
- **Real Estate Loans** - Finance companies offer real estate loans in the form of mortgages on commercial real estate and second mortgages on residential real estate.
- **Summary of Uses of Funds** – The uses of funds depends on whether the finance company is focused on business or consumer lending.

Exhibit 22.1 How Finance Companies Finance Economic Growth



Interaction with Other Financial Institutions

- When finance companies obtain or use funds, they interact with other financial institutions.
- Finance companies compete with commercial banks, savings institutions, and credit unions.
- Finance companies utilize various financial markets to manage their operations.

Exhibit 22.2 Interaction between Finance Companies and Other Financial Institutions

TYPE OF FINANCIAL INSTITUTION	INTERACTION WITH FINANCE COMPANIES
Commercial banks and savings institutions	• Compete with finance companies for consumer loan business (including credit cards), commercial loans, and leasing.
Credit unions	• Compete with finance companies for consumer loan business.
Securities firms	• Underwrite bonds that are issued by finance companies.
Pension funds	• Compete with insurance subsidiaries of finance companies that manage pension plans.
Insurance companies	• Compete directly with insurance subsidiaries of finance companies.

Exhibit 22.3 Participation of Finance Companies in Financial Markets

TYPE OF FINANCIAL MARKET	PARTICIPATION BY FINANCE COMPANIES
Money markets	• Finance companies obtain funds by issuing commercial paper.
Bond markets	• Finance companies issue bonds as a method of obtaining long-term funds. • Subsidiaries of finance companies commonly purchase corporate and Treasury bonds.
Mortgage markets	• Finance companies purchase real estate and also provide loans to real estate investors. • Subsidiaries of finance companies commonly purchase mortgages.
Stock markets	• Finance companies issue stock to establish a capital base. • Subsidiaries of finance companies commonly purchase stocks.
Futures markets	• Subsidiaries of finance companies that offer insurance-related services sometimes use futures contracts to reduce the sensitivity of their bond portfolio to interest rate movements and may also trade stock index futures to reduce the sensitivity of their stock portfolio to stock market movements.
Options markets	• Subsidiaries of finance companies that offer insurance-related services sometimes use options contracts to protect against temporary declines in particular stock holdings.
Swap markets	• Finance companies may engage in interest rate swaps to hedge their exposure to interest rate risk.

Exposure of Finance Companies to Risk

Liquidity Risk

Finance companies generally do not hold assets that could be easily sold in the secondary market. However, their balance sheet structure does not call for much liquidity.

Interest Rate Risk

Both liability and asset maturities of finance companies are short or intermediate term. Therefore, they are not as susceptible to increasing interest rates as savings institutions are.

Credit Risk

Credit risk is a major concern because the majority of funds are allocated as loans to consumers and businesses.

Factors That Affect Cash Flows

$$\Delta V = f(\Delta E(CF), \Delta k)$$

- **Economic Growth**

  Can enhance a finance company's cash flows by increasing household demand for consumer loans, thereby allowing the finance company to provide more loans.

- **Change in the Risk-Free Interest Rates**
  - Cash flows may be inversely related to interest rate movements.
  - Finance companies rely heavily on short-term funds

Valuation of a Finance Company

Factors that Affect Cash Flows (Cont.)

- **Change in Industry Conditions**

  Conditions include regulatory constraints, technology, and competition within the industry.

- **Change in Management Abilities**

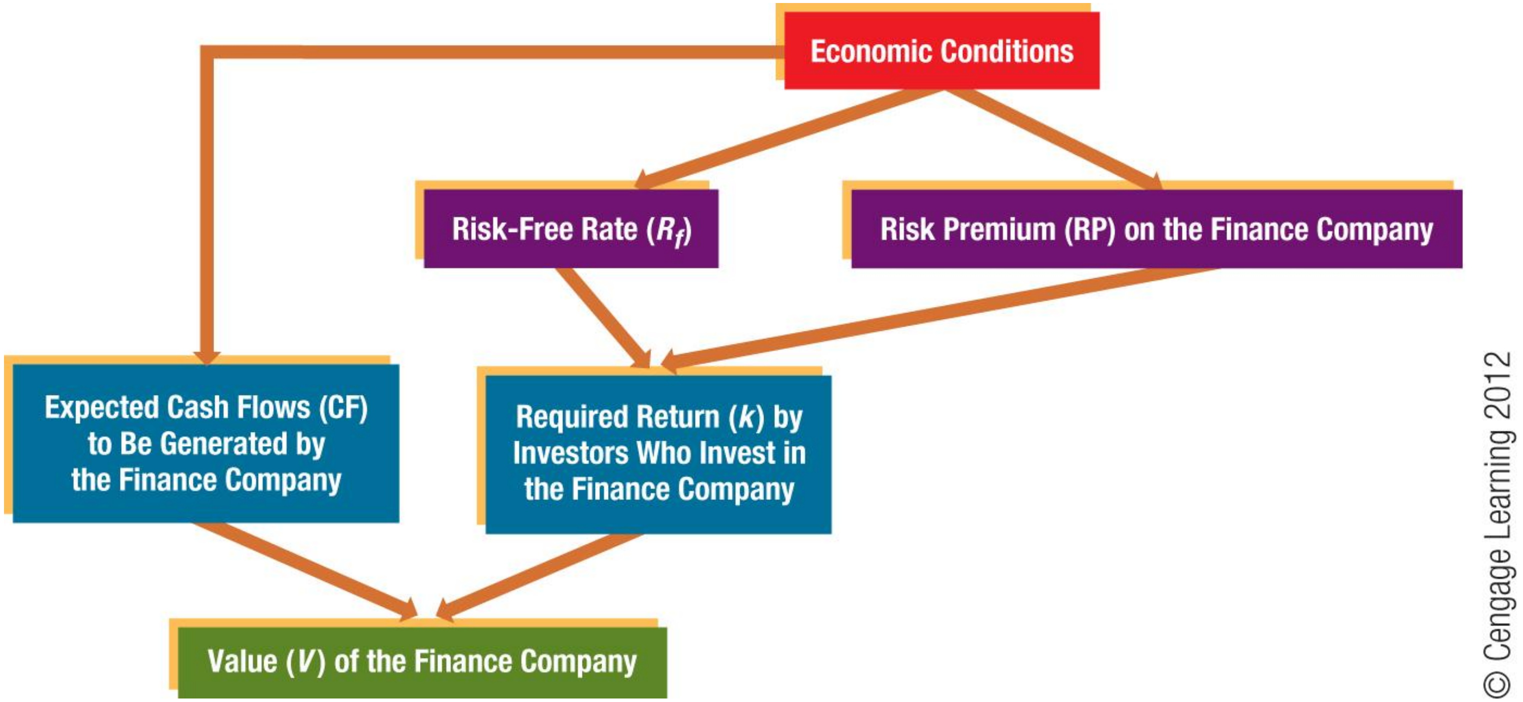
  Managers attempt to make internal decisions that will capitalize on external forces (economic growth, interest rates, regulatory constraints).

Factors That Affect the Required Rate of Return

$$\Delta k = f(\Delta R_f, \Delta RP)$$

- The risk-free rate is positively related to inflation, economic growth, and the budget deficit level, but inversely related to money supply growth (assuming it does not cause inflation)
- The risk premium is inversely related to economic growth and the company's management skill.

Exhibit 22.4 Framework for Valuing a Finance Company



Multinational Finance Companies

- Some finance companies are large multinational corporations with subsidiaries in several countries.
- For example, GE money provides consumer finance services in 55 countries and serves more than 130 million customers around the world.

SUMMARY

- Finance companies are classified by type. A consumer finance company provides financing for customers of retail stores or wholesalers, while a business finance company offers loans to small businesses. A captive finance subsidiary (CFS) is a wholly owned subsidiary whose primary purpose is to finance sales of the parent company's products and services, provide wholesale financing to distributors of the parent company's products, and purchase receivables of the parent company.
- The main sources of finance company funds are loans from banks, sales of commercial paper, bonds, and capital. The main uses of finance company funds are consumer loans, business loans, leasing, and real estate loans.

SUMMARY (Cont.)

- Finance companies are exposed to credit risk as a result of their consumer loans, business loans, and real estate loans. They are also exposed to liquidity risk because their assets are not very marketable in the secondary market. They may also be exposed to interest rate risk.
- Finance companies are valued as the present value of their expected cash flows. Their valuation is highly dependent on economic conditions because there are more requests for loans by qualified borrowers when economic conditions are favorable. In addition, the amount of loan defaults is normally lower when the economy is strong.

SUMMARY (Cont.)

- Finance companies compete with depository institutions (such as commercial banks, savings institutions, and credit unions) that provide loans to consumers and businesses. Many finance companies have insurance subsidiaries that compete directly with other insurance subsidiaries.